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July 8, 1999

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: *Ex Parte* Statement
Direct Access to the INTELSAT System
IB Docket No. 98-192

Dear Ms. Salas:

On June 30, 1999, MCI WorldCom, Inc. ("MCIW") submitted an *ex parte* statement in the above-referenced proceeding which included copies of a presentation to the International Bureau. COMSAT Corporation ("COMSAT") hereby responds to that statement. We respectfully request that this response be made part of the record in this proceeding.

In its comments and reply comments, and in *ex parte* statements submitted on June 11 and June 28, 1999, in response to questions from the International Bureau staff, COMSAT demonstrated that INTELSAT Utilization Charges ("IUCs") do not fully compensate COMSAT for its investment in INTELSAT, or for the costs it incurs in fulfilling its statutory obligations as U.S. Signatory to INTELSAT. Hence, a surcharge would be necessary if the Commission were to adopt Level 3 direct access. In its June 30 statement, MCIW essentially acknowledges that a surcharge would be required, but attempts to challenge the levels justified by COMSAT. In particular, MCIW tries -- but fails -- to show that COMSAT has understated the size of the IUC-based return.

The following discussion addresses, page by page, the claims in MCIW's presentation to the International Bureau.

Page 1. MCIW first claims that "COMSAT's Arguments Focus on the Trees, not the Forest." In fact, the "forest" consists of the 101 price-cap and non-price-cap companies earning higher returns than INTELSAT as measured by the FCC's own method. MCIW

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ignores that forest, and concentrates on a few "trees" of its own choosing. We show below that its description of those trees is incorrect.

Contrary to MCIW's assertions, the fact that "COMSAT has voluntarily increased its investment in INTELSAT" does not undermine COMSAT's position with respect to the surcharge amounts we submitted. COMSAT did increase its ownership share by about 2% in accordance with INTELSAT's Article 6(d) procedures, and that action does "make[] good business sense" for the reasons discussed below. However, that does not mean that a return based solely on the IUC would be compensatory if Level 3 direct access were to be imposed.

As we explained in our June 28 statement, surplus ownership under Article 6(d) is held voluntarily on a year-to-year basis. This limits COMSAT's downside risk and, together with the benefits enumerated below, makes surplus ownership acceptable *compared to other small-scale short-term investments*. Absent a surcharge, however, it would *not* be financially acceptable for COMSAT to hold virtually its entire INTELSAT investment on a "ownership only" basis, as would be the case under Level 3 direct access. That type of ownership would have a much higher risk factor than COMSAT's current surplus ownership, because it would not be discretionary and could not be returned after one year. Thus, it would require a higher level of compensation than that provided by the IUC alone.

Surplus ownership in small amounts also has other benefits, as we pointed out earlier. Consistent with U.S. policy, it helps other Signatories in lesser developed countries who cannot take their full ownership share, and strengthens the system as a whole by increasing its universal coverage and connectivity. Moreover, it increases COMSAT's voting power in INTELSAT, which helps serve U.S. interests in areas such as procurement, and is especially critical today in light of the U.S. effort to achieve a pro-competitive privatization. These factors also explain the statement by COMSAT's President and CEO that COMSAT's current surplus ownership "makes good business sense" -- but that in no way undercuts our showing with respect to the need for a direct access surcharge.

MCIW's assertion that "if there is a Signatory Surcharge, the difference between INTELSAT market value and book value should be distributed to U.S. users on privatization" is so absurd that one wonders whether it is meant to be taken seriously. If it is, the short answer is that any attempt by third parties to use direct access to expropriate COMSAT's property as an incident of INTELSAT privatization is unfair and unlawful and should be rejected. Having taken all the risk of investing in INTELSAT for the past 35 years, COMSAT's shareholders are entitled to any economic benefit that may result from INTELSAT privatization.

MCIW does not and cannot show any connection between the surcharge issue and the market value of a privatized INTELSAT. We have shown that INTELSAT's cooperative return is not a commercial return, but that obviously has no bearing on the expected value of INTELSAT as a privatized business. The reasons for the surcharge are (1) to make up for the fact that giving non-members access to a cooperative at cooperative member prices is non-compensatory and unfair; and (2) to ensure that the costs COMSAT incurs in fulfilling its statutory obligations are properly borne by all users. Once INTELSAT is privatized and COMSAT is no longer a Signatory, there will be no need for a surcharge.

Page 2. The claim that "Direct Access Would Not Allow U.S. Carriers to Set IUCs" knocks down a straw man. COMSAT never argued that U.S. carriers could set IUCs themselves. Rather, we showed: (1) that the IUC return alone is not compensatory now; (2) that COMSAT, which has only about a 20% voting share in INTELSAT, cannot control the level of the IUC return; and (3) that the foreign Signatories who do control the level of the IUC return have a common interest with the carriers in keeping the IUCs low.

As pointed out in our comments (and in the supporting analysis by The Brattle Group), COMSAT is the sole "pure play" investor in INTELSAT. In contrast, other Signatories, like the U.S. carriers, are primarily interested in INTELSAT as a source of supply. Thus, while direct access would not literally allow U.S. carriers to set IUCs, it would give them influence over the process which, in the absence of a surcharge, they could use (by working with their foreign Signatory correspondents, who have similar supply interests) to advantage themselves and disadvantage COMSAT.

As major direct access customers of INTELSAT, U.S. carriers could be expected to use their bargaining leverage to push for low IUCs. Most foreign Signatories -- which have generally balanced INTELSAT ownership and utilization shares -- would not suffer from a lowering of IUCs because any losses associated with ownership (in terms of reduced returns through lower IUCs) would be offset by gains associated with the use of the same space segment in the provision of their own retail services. While some foreign Signatories do hold investment on behalf of Level 3 direct access users in their countries, such "net ownership" is relatively small, and would be far smaller than COMSAT's. Moreover, those foreign Signatories with "deficit ownership" (i.e., usage in excess of ownership) would clearly benefit from lower IUCs. As a consequence, the overall loser from low IUCs would be COMSAT -- the sole pure-play INTELSAT investor.

The prospect of large potential gains at COMSAT's expense creates a considerable risk that the carriers could convince their foreign Signatory correspondents to outvote COMSAT and reduce the IUCs. The sizable gains to carriers would even allow them, if necessary, to compensate foreign Signatories for any small losses they might incur by adopting non-compensatory IUCs -- for example, by diverting traffic to jointly owned facilities.

MCIW's points about the Board of Governors setting the IUCs and there being a requirement to include compensation for the use of Signatory capital add nothing to this debate -- and the suggestion that the INTELSAT Operating Agreement mandates a target rate of 17-21% per year is false. The Agreement does not mention any particular compensation rate. Moreover, as pointed out previously, the target rate set by the Board has little meaning and is even adjusted after the fact to match the actual results. INTELSAT is a cooperative, and its members decide what level of compensation is adequate to maintain the liquidity needed to cover for members who cannot buy their full ownership share of the investment. The cooperative structure serves users and the prevailing perspective is that of users, not investors.

Page 3. MCIW's contention that "IUCs Are Market Prices" is incorrect and misleading. IUCs may be used for direct access in 94 countries, but in all but one of those countries (Argentina), the Signatory itself remains by far the largest user of INTELSAT capacity, so direct access is only of marginal significance. Under these circumstances, it is wholly inaccurate to represent the IUCs as market prices. In any event, MCIW has failed to rebut COMSAT's showing that the IUCs do not compensate COMSAT for its investment in INTELSAT or for the costs it incurs as U.S. Signatory, and that failure is dispositive.

The related argument that "COMSAT sells to end users" is similarly disingenuous. COMSAT, by Congressional design, is primarily a carrier's carrier. Hence, if U.S. carriers were to obtain direct access, COMSAT, without an adequate surcharge, would be severely damaged. In contrast, other Signatories are primarily telephone companies. For them, INTELSAT capacity is a minor investment, but for COMSAT, it is a major investment *and* a major source of revenue. Other Signatories may well be able to live with "zero or nominal IUC surcharge," but COMSAT, because of its dependence on its INTELSAT business, is not one of them.

Page 4. The centerpiece of MCIW's presentation is its attempt to show that "IUCs Fully Compensate COMSAT for its Investment in INTELSAT." Mathematics is a wonderful thing -- one can add, subtract, multiply and divide all kinds of numbers. However, such calculations are not necessarily meaningful. In this case, MCIW's calculations mean nothing. MCIW substitutes return on equity (or invested capital) for return on rate base, confuses INTELSAT accounting with GAAP accounting, and applies the wrong tax rate for a surcharge calculation. The result is a useless mess.

MCIW asserts that COMSAT's IUC-generated return on invested capital in 1998 was 12.88%, and suggests that this return is "fully consistent" with COMSAT's (formerly) authorized return of 12.48%. MCIW is wrong. Even if the 12.88% figure were correct -- which it is not, for the reasons stated below -- a return on invested capital is not comparable to a return on rate base; the denominators used in the calculation are too dissimilar. That is why, to permit an apples-to-apples comparison, we converted the IUC-based return to a return on average net plant, which is the measure used in the Commission's Rate of Return Report. That return, after tax, was *8.72%* in 1998, compared to a weighted average return of *15.94%* for the price cap companies.

MCIW also asserts that COMSAT's IUC-generated return on invested capital in 1998 should be subject to a .7405 "tax adjustment." Again, MCIW is wrong. The .7405 figure was obtained by using COMSAT's 1998 effective tax rate of 25.95%, which is not characteristic of future tax rates, rather than its marginal tax rate of 37.31%, which is in line with standard corporate tax rates. Setting a surcharge (or any other rate) is a forward-looking exercise. Thus, extraordinary, non-recurring items are extraneous to a proper calculation for rate making purposes. The only proper measure is the standard tax rate. Applying that rate, and the corresponding adjustment of .6269, reduces the IUC-generated after-tax return on invested capital for 1998 to *9.28%* (0.148 x (1 - .3731)).

MCIW further asserts that COMSAT's return on invested capital in 1998 should be subject to a 1.16 "equity adjustment." Once more, MCIW is wrong. The 1.16 figure relates to the "excess return" which, according to MCIW, INTELSAT used to increase its equity in 1997 by 16%. However, MCIW conveniently ignores the fact that, in 1998, INTELSAT eliminated the excess return in order to conform to GAAP accounting and to avoid understating its equity. (Incidentally, INTELSAT used to set its target return at 14%.) INTELSAT's change in accounting returns net book value to the level it should have according to GAAP. Thus, MCI's 16% "equity adjustment" is an attempt to return INTELSAT to non-standard accounting procedures at a time when it is seeking to bring its procedures into conformance with GAAP and other commercial practices.

For all these reasons, MCIW's claim that INTELSAT earned a 12.88% after-tax return on invested capital in 1998 is false. But even the 12.88% figure is a far cry from the mythical 18% and 21% returns touted for so long as *prima facie* proof that COMSAT would not be negatively affected by direct access. If nothing else, MCIW has finally acknowledged that the return figures reported by INTELSAT must be adjusted for taxes. Now, perhaps, it will explain why 9.28% on invested capital is a sufficient return for COMSAT when the price cap companies earn almost 16% on *average net plant* -- a much larger denominator.

Page 5. Despite MCIW's empty rhetoric (see "COMSAT Surcharge Calculation -- Summary"), our surcharge calculations are not "substantially inflated," and we have demonstrated that fact in detail in our previous submissions. Moreover, MCIW's claim that a "higher surcharge based upon price-cap carriers' returns is unjustified in the absence of efficiency incentives for COMSAT" is incorrect for at least three reasons.

First, under MCIW's analysis, COMSAT's efficiency incentives are irrelevant; what matters are *INTELSAT's* incentives. The entire direct access argument is based on the assumption that the IUCs are competitive rates that generate competitive returns. For that to be true, INTELSAT *must* have efficiency incentives; if it does not, the whole premise for direct access evaporates.

Second, COMSAT *does* have "efficiency incentives." As a result of the Commission's actions in the 1998 Non-Dominance Order and the 1999 Incentive Regulation order, over 90% of COMSAT's INTELSAT traffic is on routes that the agency specifically concluded were competitive, and the rest is now subject to incentive-based regulation. Indeed, the Commission could not have eliminated rate-of-return regulation for COMSAT if it had *not* found that COMSAT had "efficiency incentives." Thus, it is entirely appropriate to compare the IUC-based return to the returns enjoyed by price-cap carriers.

Third, MCIW's argument implies that COMSAT is asking to be guaranteed a return equal to that of the price cap carriers. That is most certainly *not* the case. We are simply pointing out that, *if* the Commission adopts Level 3 direct access, it must also adopt a surcharge that adequately compensates COMSAT given its position in the marketplace today. Obviously, our position is that the Commission should not adopt direct access at all.

Page 6. MCIW's claim that our surcharge calculation "makes no sense" (see "Surcharge Calculation -- 18.22% Surcharge to Raise INTELSAT Return Makes No Sense") is a self-serving attempt to excuse MCIW's failure to address COMSAT's "plain as day" results. Despite MCIW's claim that the "proper focus is on COMSAT['s] equity investment in INTELSAT," it is difficult to see how one can rationally apply INTELSAT's return on Signatory capital to COMSAT but not its return on average net plant. Again, the latter measure is the one used *by the Commission itself* to compute and compare the returns earned by U.S. carriers.

In any event, our calculations do show the return *to COMSAT* that would flow from the IUC. We do not assume that "INTELSAT is taxed at COMSAT's rate." Rather, we assume that *COMSAT's revenue distribution from INTELSAT* is taxed at COMSAT's rate. And we do not assume that the "IUC surcharge would be paid to INTELSAT" (although, for purposes of showing the shortfall and the surcharge needed to correct it, it does not really matter to whom the surcharge is paid). Rather, we assume that the surcharge would be paid to COMSAT, to cover *its* costs and provide a return on *its* investment.

Page 7. Finally, and again contrary to MCIW's claims (see "Surcharge Calculation -- COMSAT Data Does Not Support 'Investing Signatory Surcharge'"), all of the expense items claimed by COMSAT are properly recoverable. We have demonstrated that prudent business practice requires COMSAT to insure against launch and in-orbit failure to the extent that INTELSAT does not do so itself. Moreover, even assuming *arguendo* that "most of COMSAT's 'Estimated Signatory Function Expenses' are to protect COMSAT's investment," those expenses are still recoverable because COMSAT's investment in INTELSAT is compelled by U.S. law. It is true that those expenses are a relatively small percentage of COMSAT's total IUC payments, but: (1) that is irrelevant, and (2) it is also true that the absolute level of those expenses is increasing because of the costs associated with advocating privatization in accordance with U.S. government instructions. Accordingly, any surcharge must be set at a level that will recover these expenses, as well as COMSAT's other costs.

Respectfully submitted,

Keith H. Fagan

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AFFIDAVIT OF THEODORE W. BOLL

I am Director, Financial Planning and Analysis, for COMSAT Satellite Services, a division of COMSAT Corporation. I have read, and helped prepare, the *ex parte* statements by COMSAT dated June 28, 1999, and July 8, 1999, relating to the need for a direct access surcharge. I declare under penalty of perjury that the statements contained in those documents are true and correct to the best of my knowledge and belief.

Theodore W. Boll

Subscribed and sworn before me this 8th day of July, 1999.

Notary Public

Darrick Johnson
NOTARY PUBLIC STATE OF MARYLAND
My Commission Expires December 15, 1999